Dewey Julia M

From: Dewey Julia M
Sent: Thursday, December 19, 2002 11:09 AM
To: [redacted]
Cc: [redacted]
Subject: [redacted] Early Disposition of Debt

Importance: High

This message is to pass along further comments on the advisory memorandum which we sent to you on November 21, 2002, concerning the time in which certain expenses and costs accrued. These were incurred in connection with the early buy-back of bonds (issued by [redacted]), set up to occur at the time [redacted]s merged with [redacted]

As we previously informed you, our memorandum was also sent for review to the Income Tax & Accounting branch at Chief Counsel's National Office. Gwen Turner, one of their technical experts on "all events test" issues recommended that we change our advice to you in one particular. It is her opinion, with regard to the "economic performance" requirement for the consent payments, that this requirement was not met until payments actually were made to the consenting bondholders. In our analysis we concluded that, since the bondholders had done all they were required to do in order to be entitled to the consent payments, the economic performance requirement had been met, prior to the close of [redacted]s final tax year, under Treas.Reg. sect. 1.461-4(d)(2). This determination rested on a characterization that, by submitting the consents and tendering the notes, the bondholders were rendering or performing a service. The National Office advises us that this is an incorrect characterization--that the bondholders were merely performing under a contract, all of the conditions of which had not yet been met at that time; they were not performing a service for the taxpayer, within the meaning of this regulation. Thus, because no specific rule regarding the of factual situation at issue can be found in the "economic performance" regulations, Ms. Turner concludes that the applicable regulation is sec. 1.461-4(g)(7), which provides, in relevant part: "In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section...economic performance occurs as the taxpayer makes payments in satisfaction of the liability...." This analysis does not change our basic advice to you that the "first prong" of the "all events test was not satisfied until after the close of [redacted]'s final tax year; rather, it adds another reason for concluding that the "all-events" test had not been met by that time--since economic performance did not occur until payment was made, and that occurred at least a day after the merger of the two companies.

Ms. Turner also recommended that we add the following caveat to our advice: that our response is based on the assumption that the costs in question are not required to be capitalized. As you know, you did not request our advice concerning whether or not these costs, incurred in relation to a merger, might properly be capitalized. However, I did consider this possibility and informally consulted with the Counsel industry advisors on Capitalization and Mergers & Acquisitions, both of whom were of the opinion that such costs were currently deductible and that the taxpayer should not be required to capitalize them as part of the cost of the merger. After reviewing the tax services and some case law in this area, I agreed this advice; thus the possibility of capitalization was not addressed in the advisory.

If you have any question about this message or about our advice, please call me at [redacted]

020421

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:POR:POSTF-146111-02
JMDewey

date: November 21, 2002

to: Manager, LMSB Exam Group [redacted]
Attn: [redacted], Team Coordinator

from: Area Counsel
(Communications, Technology, and Media: Oakland)

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subject: **Economic Performance: Deductibility of Payments Made for the Early Disposition of Debt**

Taxpayers: [redacted] ("[redacted]") [redacted] ("[redacted]")

DISCLOSURE STATEMENT

This writing may contain privileged information, and any unauthorized disclosure of it may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. This memorandum should not be cited as precedent.

INTRODUCTION

You have requested our advice on the issue of when certain costs incurred by [redacted] were actually accrued under the provisions of I.R.C. § 461. These costs--"consent payments," "premiums," "interest" and agent's fees--were incurred in connection with the buy-back of [redacted] debentures which had not yet matured. The buy-back was organized preliminary to the merger of [redacted] with [redacted], which occurred in [redacted].

As discussed below, and based on the facts which have been provided to us, we conclude that the liability to pay the offer payments (including premiums) and consent payments did not accrue until the financing arrangements were completed and the merger was consummated on [redacted]. Similarly, we (provisionally) conclude that the agent's fees became due and thus accrued on [redacted]. However, it is our opinion that most of the interest accrued prior to this date.

FACTUAL BACKGROUND

[redacted].

Both [redacted] and [redacted] were and are accrual-basis taxpayers. On [redacted] the two companies merged, after which [redacted] filed a final "short year" return reporting a net operating loss for the period from [redacted] to [redacted]. Beginning with the date of the merger, [redacted] has been included in [redacted]'s consolidated return. [redacted] is a CIC taxpayer and its return for the year of the merger, ending on [redacted], is now under examination.

On [redacted], [redacted] and [redacted] entered into an Agreement and Plan of Reorganization and Merger (the "Merger Agreement"). Under this agreement, the merger of the two companies was scheduled to occur on [redacted], with both entities becoming subsidiaries of a parent holding company which was renamed [redacted]. Under the Joint Proxy/Prospectus that was filed on [redacted], one of the conditions for the merger was that the majority of [redacted]'s outstanding indebtedness would be repaid. Thus, [redacted] was to "refinance" approximately $[redacted] in debt for bonds which it had issued on [redacted], by buying back at least a majority (based on principal) of the notes described as "[redacted]," none of which were held by [redacted] or its subsidiaries. Under the terms of the original indenture agreement, the earliest date on which [redacted] could redeem these bonds was [redacted].

The stated purpose of the "buy-back" was to reduce the existing indebtedness of [redacted] and to remove restrictive covenants and other limitations on the remaining indebtedness so that the new [redacted] holding company would have increased access to [redacted]'s facilities and cash. The merger and the buy-back transactions were to be financed with funds provided by the Credit Facility and the Lease Facility being set up by the new [redacted] holding company. The planned "refinancing" was to include the retirement of the "old" debts of [redacted] and [redacted] but was not expected to change in any material respect the total debt held by the merged companies. Financing arrangements were expected to be completed on or about the effective time of the merger. The Offer to Purchase document states that [redacted] had already received a Financing Commitment letter from the banks who were planing to provide the sources of funds required (up to $[redacted]). The Offer to

Purchase asserts that the whole refinancing process would "facilitate the financing for the Merger on advantageous terms."

To effect the buy-back, [redacted] entered into a Dealer Manager and Solicitation Agent Agreement with [redacted] on [redacted]. On the same date, all bondholders (Holders) were issued an Offer to Purchase and Consent Solicitation. Under the Offer, in order to receive the "offer payment," Holders were required to validly tender their Notes by the "expiration date." Moreover, in order to receive an additional payment (the "consent payment"), each Holder was required to deliver his Consent to certain proposed amendments to the original indenture and to validly tender his Note(s) by an earlier date, the "consent date." The proposed amendments to the indenture would eliminate substantially all restrictive covenants and modify certain other provisions in the agreement, including some default provisions. Under the terms of the Offer, Consents could not be revoked nor tendered Notes withdrawn after the consent date unless the Offer to Purchase was terminated.

The expiration date of the Offer was scheduled for [redacted] time on [redacted], unless extended for specified reasons. This date was to occur on the same day, or shortly after, the merger of [redacted] and [redacted], and [redacted] stated its intention to extend the Offer, if necessary, so that these dates would coincide.

The consent date was set for one day after a public announcement (a press release) had been made that the "Requisite Consents" had been given (that is, that Consents from at least a majority, by principal, of all the bondholders had been received). The date of the public announcement (the "consent achievement date") was to occur no earlier than [redacted] time on [redacted]. On the consent date, [redacted] was then to deliver to the indenture Trustee an officer's certificate stating that a majority of the bondholders had agreed to the proposed amendments. As soon as practical thereafter the Trustee would issue a Supplemental Indenture incorporating the amendment.

The offer payment was to be at least $[redacted] for each $[redacted] of principal held by the bondholder. This amount might be greater, as calculated by a complex formula which depended on the bid price for a certain reference security ([redacted]% U.S. Treasury Notes due [redacted]) on the "price determination date" (anticipated to be [redacted]). In addition, an amount equal to all unpaid interest which had accrued on the Notes up to (but not including) the payment date would be paid. Payment was to be made shortly after acceptance by [redacted] of the Notes tendered. Acceptance was anticipated to occur on the expiration date (planned for [redacted]) and payment to be made on the next business day.

The consent payment was to be $[redacted] for each $[redacted] of principal held by the consenting Holder, if the related Notes were also tendered. All Holders who validly tendered their Notes pursuant to the Offer to Purchase were deemed to have consented to the proposed amendments; however, a Holder would not receive a consent payment unless his Consent (and tendered Notes) had been received by the consent date. Consent payments were to be made on the same day as the offer payments.

Under the Offer to Purchase document, the obligation of [redacted] to accept for purchase the Notes tendered and to make the consent payments was subject to the following conditions: (a) Not less than a majority (in aggregate principal amount) of the outstanding Notes must be validly tendered, and not withdrawn, prior to the expiration date and the "Requisite Consents" to the proposed amendments must have been received (the "Minimum Condition"); (b) the Trustee must have executed the Supplemental Indenture; (c) the merger and planned financing transactions must have been consummated (the "Transactions Condition"); and (d) certain other events or conditions described in the Offer (including an adverse change in the listed price of the notes, a national emergency and/or legal or governmental actions which would materially impact the Offer) must <u>not</u> have occurred. [redacted] reserved the right to waive any of the conditions to the Offer(before its consummation), to extend it, to amend it, or (if the above-listed conditions had not been met) to terminate it.

On [redacted], an amendment to the Offer was filed by [redacted]. This document, entitled "Supplement to Offer to Purchase and Consent Solicitation Statement" (Supplement), stated that on [redacted], the "Requisite Consents" were received. (Thus, under the terms of the Offer and this Supplement, those Consents already given could not now be withdrawn.) Additionally, the Supplement increased the consent payment from $[redacted] to $[redacted] per $[redacted] of principal, and changed the formula for calculating the offer payment. Holders who had already consented and tendered their Notes would receive the benefit of these changes in consideration without taking further action. However, for Holders who had not yet consented or tendered Notes, the revised consideration was offered for Consents submitted and Notes tendered by the expiration date, that is, by [redacted] time, [redacted] (if not extended).

Your statement of the facts does not indicate when the officer's certificate (affirming that the "Requisite Consents" had been received) was given to the indenture Trustee nor when that entity issued the Supplemental Indenture. However, based on the terms of the Offer and the Supplement, we assume that this occurred on or shortly after [redacted]. Also, no information is given concerning the date(s) on which the required "financing transactions" were completed, although the Offer states that this was to be "on or about the effective time of the merger." You state that the merger was consummated on [redacted], and we assume, based on the Offer document, that the Offer period was extended to this date, the notes which had been tendered were accepted by [redacted] and the Offer was consummated on that day. The analysis and conclusions set forth below are based on these assumptions and on the facts and documents you have provided to us.

Also on [redacted], [redacted] issued an invoice to [redacted] for its $[redacted] fee ([redacted]% of the aggregate principal amount of the Notes tendered) and [redacted] transferred funds to [redacted] to pay for the Notes (including principal, premium and interest) and to make the consent payments. The amounts to be paid from these funds were:

Aggregate principal amount of Notes	$[redacted]
Premiums due on Notes	
Aggregate purchase price of Notes	
Consent Payments Due	[redacted]
Interest Expense	[redacted]

On its [redacted] consolidated return, [redacted] claimed deductions for agent's fees, interest expense and the costs incurred by [redacted] in "writing off" $[redacted] of its bond debt. The "write-off" amount claimed was $[redacted] (comprising the "premiums" and "consent payments" listed above). However, you question the taxpayer's assertion that these liabilities accrued on or after [redacted]. You suggest that the merger with [redacted] which occurred on [redacted] was merely a "condition subsequent" to the bond buy-back transaction and that [redacted] actually accrued some or all of the related costs prior to the date of the merger. Thus, your position is that deductions for these costs should have been claimed on [redacted]'s return for the period ending on [redacted]. Your have requested our analysis and advice concerning this proposition.

GENERAL LEGAL PRINCIPLES

The tax accounting rule which determines when an accrual basis taxpayer must recognize, and claim a deduction for, an item of expense is termed the "all-events" test. As expressed by the

U.S. Supreme Court in U.S. v. Anderson, 269 U.S. 422, 441 (1926), and many other cases, this test has two "prongs." It provides that a liability is incurred and must be taken into account for the taxable year in which (1) all the events have occurred which establish the fact of liability and (2) the amount can be established with reasonable accuracy.

Income tax regulations incorporate this test and also include a "third" requirement, enacted in July 1984 and encoded as I.R.C. § 461(h)(1), which provides that the all-events test cannot be met any earlier than the time when "economic performance" occurs. See Treas. Reg. §§ 1.446-1(c)(1)(ii)(B) and 1.461-1(a)(2). Generally, this requirement is met either when services or property (or the use of property) are provided to a taxpayer or a taxpayer provides services or property to another. See section 461(h)(2)(A) and Treas. Reg. § 1.461-4(d). For liabilities which arise from the provision of services or property to the taxpayer by another, economic performance occurs as the services or property are provided. Treas. Reg. § 1.461-4(d)(2). For interest liabilities incurred by a taxpayer for the use of money, economic performance occurs as the interest cost economically accrues. Treas. Reg. § 1.461-4(e).

One of the fundamental premises underlying the "all events" test is that, although expenses may be deductible before they become due and payable, liability must first be firmly established. U.S. v. General Dynamics Corp., 481 U.S. 239, 243 (1987). Thus, even when economic performance occurs, and the amount of a debt can be established with reasonable accuracy, a liability will not accrue if the fact of liability cannot be established, because the debt is contested or because it remains contingent upon the occurrence of a future event. For the "first prong" to be met, a liability must be a valid, enforceable obligation that establishes an obligation to pay which is certain, and not dependent upon the happening of some contingency. Such a liability becomes "fixed" when payment is unconditionally due or the performance required of the other party has occurred. Rev. Rul. 80-230, 1980-2 C.B. 169; Helvering v. Russian Finance & Construction Corp., 77 F.2d 324 (1935).

However, whether "all the [required] events" have occurred in a given situation--whether a specific event comprises a contingency which, if not met, would prevent accrual for tax purposes--is not always easy to determine. Not all "future events" which might have an impact on a liability will be viewed as contingencies which prevent accrual. For example, events such as the possible death of a payee, have been held to impact the amount of the liability (the "second prong" question), but not the fact that a liability has been incurred (the "first prong" question). See, for example, Burnham Corporation v. Commissioner, 878 F.2d 86 (2nd Cir., 1989).

On the other hand, if a taxpayer's obligation has been "fixed" (under the definition discussed in Rev. Rul. 80-230, cited above) but there is a possibility that it might be reduced or discharged by some later event, this will not prevent accrual, particularly if the event is considered unlikely, unexpected or speculative. See Helvering v. Russian Finance & Construction Corp., supra. The courts frequently refer to the distinction between future events which prevent accrual and those which do not as "conditions precedent" and "conditions subsequent."

A future event which is "ministerial" or routine in nature, is likely to be deemed a "condition subsequent." In the General Dynamics case, however, the arguably-routine filing of claims was not so classified. The taxpayer in that case maintained a self-insured medical plan for employees and claimed accruals for estimated liabilities for employees who had received medical services but had not yet filed claims for reimbursement. The government argued and the Court agreed that the liabilities were not "fixed" until claims were filed because beneficiaries might neglect to file for covered expenses for various reasons. The Court found that it simply was not expected that claims would be filed in all cases.

On the other hand, in U.S. v. Hughes Properties, 476 U.S. 593 (1986), the Court held that a casino had accrued liabilities for "progressive jackpots" on its slot machines, because Nevada State law mandated that the "progressive" amounts which had accumulated on the machines could not be reduced. The government argued that the casino would have no liability if gamblers ceased playing the machines, so that a jackpot was never reached, or the casino went out of business, but the Court apparently considered these possibilities to be unlikely "conditions subsequent." State law was held to have "fixed" the liabilities in this case.

ANALYSIS

A. Accrual of Premiums and Consent Payments.

The Offer to Purchase at issue in this case clearly sets out what a Holder must do, and when, in order to receive offer and consent payments. To an extent, this Offer is one-sided: to be entitled to payment a Holder must submit a Consent and tender his Note(s) in a timely manner, but these actions, by themselves, do not bind the corporation to accept the Notes or make payment. Instead, there are a number of additional conditions which must be met before the Company becomes bound to perform.

We do not know the exact number (by principal amount) of bondholders who had consented and tendered their Notes by [redacted], and you may wish to ask for the taxpayer for this information. However, it is clear that at least a majority of the Holders had taken the actions required of them, in order to be entitled to payment, by that date.[1] Furthermore, the Offer provided that, as of this date, the Holders that had given their Consents could not reverse this action or take back their Notes. Thus, the "economic performance" requirement for these Holders had been met. Since the amounts they were entitled to receive could be determined with "reasonably accuracy" before the close of [redacted]'s "short" taxable year, the "second prong" of the all-events test was also satisfied for these liabilities.

However, whether or not the "first prong" of the all-events test was also met is another question. The answer depends on whether the conditions set out in the Offer must have occurred before [redacted] became obliged to compensate these Holders for their Consents and for tendering their Notes. As you point out in your memorandum, the first contingency, the so-called "Minimum Condition," was met on [redacted], when [redacted] stated in the Supplement that the "Requisite Consents" had been received.

The second condition listed in the Offer was that the indenture Trustee must have executed the Supplemental Indenture. Since the Offer document provides that an officer's certificate was to be sent to the Trustee the day after it was announced that the "Requisite Consents" had been received, and that the Trustee was to execute the Supplemental Indenture as soon as possible thereafter, it most likely that this condition was met prior to the close of [redacted]'s "short" taxable year. Also, the execution of the Supplemental Indenture is an act which appears to be "ministerial" in nature; thus, it would not comprise the kind of contingency that, by itself, would have prevented accrual.

The third listed condition (the "Transaction Condition") was that the merger and planned financing transactions must have been completed before the Offer could be consummated. Also, the Offer document stated that the Offer period would be extended, should the merger be delayed, so that the Offer would not expire until after the merger had been completed. The actions required to complete financing transactions and consummate a merger are not

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[1] We also do not know the exact number for Holders who consented and tendered their Notes during the period from [redacted] to [redacted]. Since these Notes could have been withdrawn up until the time the Offer expired, [redacted]'s obligation to accept and pay for them was incurred on the expiration date.

the kind of actions which are likely to be viewed as merely "ministerial" ones, no matter how well these events have been planned for in advance. In order to be deductible a liability must not be "merely contemplated as more or less sure to occur in the future." Weiss v. Wiener, 279 U.S. 333 (1929). It is evident from the Offer document that the details of the anticipated merger had been agreed to in advance, and that financing had been arranged, at least to the extend that promises to provide a specific amount of credit had been obtained. However, planning to take specific (legal) steps is not the same as actually taking such steps, particularly in a situation where a number of different entities were being required to execute contracts and take other legally-binding actions. We think it unlikely that the Service would prevail in litigation on the position that the consummation of the merger and the completion of the financial transactions were merely "conditions subsequent" to [redacted]'s obligations to pay under the Offer and Supplement.

The fourth condition listed in the Offer actually comprises a number of contingencies, expressed in the negative. The Offer document provides that the Offer will not be consummated if any of these conditions were to arise or events were to occur. Clearly, these contingencies were viewed by the parties to the merger as being unlikely or unexpected, but the possibilities were provided for. Thus, these are the kind of contingencies that may be viewed as "conditions subsequent," and the mere possibility that some of them might occur would not, by themselves, prevent accrual.

B. Interest Accrual.

As noted above, economic performance on the part of the lender occurs as the interest cost economically accrues. Also, under the "first prong" of the all-events test, "performance" by the lender occurs as the funds are made available for the taxpayer's use. Generally, interest is "economically accrued," so that a constant interest rate is applied periodically to the outstanding balance, and this amount is deductible for that period. Rev. Rul. 83-84, 1983-1 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213. Where the rate of interest is provided by a note or other contract, the amount of the liability is easily and accurately determinable.

Thus, in this case, [redacted]'s liability to pay interest on its bonds accrued over time, and all the interest which had accrued by the last day of its final "short" taxable year was properly deductible in that year. Your have not provided us with documents or other information setting out the specific terms under which funds were borrowed and the interest was incurred and was to be paid, so it is possible that conditions were provided in the governing agreements which might cause us to reconsider this conclusion. However, the general rule is that interest accrues and is deductible over the time the lender's money is available to the debtor, and the interest which accrues in a given taxable year, is deductible in that year.

C. Accrual of Agent's fees

As discussed above, for liabilities which arise from the provision of services to the taxpayer, economic performance occurs as the services are provided. Generally, the "first prong" requirement will be met when the amount becomes due, or the services are performed or the liability is paid, whichever occurs first, unless the liability is contested or there are unmet contingencies in the agreement or contract. If the acts of service to be performed are not discrete or "severable" under the parties' agreement, then the liability will become "fixed" when performance is substantially completed. For example, in Ad Visor, Inc. v. Commissioner, 37 T.C.M. 606, 613 (1978), legal fees did not accrue despite the performance of some services because liability was conditioned on the "continued performance of all the tasks" agreed on. See also Treas. Reg. 1.461-4(d)(6)(iv) and Hudlow v. Commissioner, 30 T.C.M. 894 (1971).

We do not have a copy of the agreement which [redacted] entered into with [redacted]. However, you have indicated that the fee was based on a percentage ([redacted]%) of the Notes that were successfully tendered. We do not know if the liability was conditioned on the consummation of the offer and/or the merger, or if the agreement contained other contingencies which might have prevented accrual. The agreement may have provided for payment for some services even if the buy-back or the merger were not successful. However, without more information on the details of the agreement, we must conclude that the liability to pay the solicitation agent became "fixed" on the date that payment became due and payable, that is, on [redacted], when [redacted] issued an invoice to [redacted], in a specific amount, for its services.

If you have further questions or comments about this memorandum, including the factual statement, our assumptions and our conclusions, please call the undersigned at (503) 326-3100, extension [redacted]. Also, if you would like further advice (informal or formal) concerning possible terms or conditions relating to [redacted]'s obligation to pay interest on its bonds or to pay fees to [redacted], please also contact Ms Dewey.

Julia M. Dewey

JULIA M. DEWEY
Attorney (LMSB)